

a downstream toll market. In such circumstances, regulatory forbearance would be warranted in the carrier access market, though not necessarily in the toll market.

In addition, Dr. Bernheim's observation that

(s)ince the demand for intermediate services is derived from the demand for complete services, the existence of market power over an intermediate service also implies that a firm has effective market power over the final service (Bernheim at 4)

makes no sense to us. A very relevant counter-example is the markets for interstate carrier access services and interstate toll. At the present time, LECs have no market power -- or any reasonable prospect of attaining market power -- in the markets for interstate long distance services. Even if legislation were to open interLATA toll markets to former Bell Operating Companies, it would take considerable time for such LECs to attain control over the market price in those markets and thus to be in a position to benefit from anticompetitive access pricing that would require market power in the retail market to be profitable. The relevant product market for carrier access services is the set of loop, switching and transport services necessary to originate and terminate calls at high-volume customer locations in a geographic market; market power in that market does not imply -- nor is implied by -- market power in the market for retail toll services.

### **C. Standards for Competitive Intensity.**

Dr. Bernheim asserts that imperfections in market definition call for "a more stringent standard to determine market competitiveness."<sup>15</sup> However, elsewhere he notes that an important aspect of carrier access service is the fact that it is an intermediate service, as opposed to a service purchased by end users for final consumption.<sup>16</sup> One obvious economic consequence of this observation is that the standard measures of the intensity of competition derived from markets for final services are likely to understate -- not overstate -- the actual intensity of competition in a market for an intermediate service. As we noted in our Comments:

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<sup>15</sup> Bernheim at 9.

<sup>16</sup> "(t)he proposed approach to the definition of relevant product markets fails to recognize that individual service components are intermediate services rather than final services" (Bernheim at 4).

the [intermediate service] nature of the carrier access markets makes it unthinkable that a customer would pay a higher price than necessary whenever a choice was possible.

- Carrier access services are sold to (essentially) three large, sophisticated multinational customers that purchase the same or similar services in every geographic market served by the LEC and all other providers. Thus, exploitation of market power that a LEC might have in one geographic market where an IXC has no alternative supplier of carrier access can be offset by its purchase decisions in other markets where the IXC has alternatives.
- Carrier access services are homogeneous: there is no reason to prefer LEC to CAP transport or self-supply at given technical specifications. Indeed, in these markets with a small number of sellers and buyers, a buyer can obtain a competitive advantage -- as well as increased redundancy -- by establishing relationships with as many sellers as possible.
- Carrier access is a large fraction of the costs of the three IXCs who compete in retail long distance markets where a small discount in the price paid for carrier access would translate into a significant competitive advantage.<sup>17</sup>

A second economic implication overlooked by Dr. Bernheim is self-supply. Conventional measures of market share and market power in the carrier access market ignore the ability of the customer (generally an IXC) to supply part or all of this intermediate service itself. If it purchases access from another IXC or a CAP, ordinary measures of the incumbent LEC's market power diminish; if it supplies the carrier access service itself, the LEC's measured market power is unchanged. Thus because this intermediate good is supplied by the IXCs themselves, LEC market share (and market power) is overestimated by the fraction of LEC and CAP carrier access demand served by the LEC.

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<sup>17</sup> Schmalensee-Taylor Comments at 30.

#### **IV. COMPETITIVE INTENSITY SHOULD BE MEASURED SIMILARLY FOR ALL COMPETITORS.**

Dr. Bernheim criticizes the Commission's proposed reforms as "not go(ing) far enough in spelling out the criteria needed to assess the intensity of competition"<sup>10</sup> and suggests six areas of concern, generally focusing on reasons why ordinary criteria used in other markets to assess competitive intensity would fail to detect market power in the carrier access markets in question. As a general observation, his comments -- and those of AT&T -- appear to pertain more to an assessment of competition in the local exchange market rather than in the specialized carrier access markets whose competitive intensity is under examination here. In particular, Dr. Bernheim endorses AT&T's proposed "metric" criterion that "at least 30 percent of subscribers in an area are in fact using alternative providers for local telephone service" (Bernheim at 17, emphasis supplied). Similarly, AT&T's competitive checklist of necessary steps "to allow effective competition to develop in the access and local exchange markets" (AT&T at 6) is certainly not necessary for effective competition in the carrier access markets alone.

We have two main concerns with Dr. Bernheim's discussion of measuring the competitive intensity of a market: (i) the role of LEC "bottleneck facilities" in the determination of LEC market power in the carrier access markets and (ii) the quantitative measure of competitive intensity proposed by Dr. Bernheim.

First, Dr. Bernheim identifies carrier access services as

unusual...because...incumbent LECs are uniquely well-equipped to undermine the development of meaningful competition, even when obvious barriers to entry are removed. Therefore, it is important to apply a much more demanding standard for evaluating potential competition for access services than is used in other contexts. (Bernheim at 12).

He goes on to identify the presence of "bottleneck" access services -- for which he cites residential local loops as an example -- as the source of this market power. While control over local loops may be a source of market power for local exchange services, it is not a relevant concern in measuring the ability of an IXC to originate or terminate traffic to a high-volume customer location.

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<sup>10</sup> Bernheim at 11.

Carrier access service -- as provided by a CAP or IXC -- generally includes the local loop, particularly for the customer class in question: high-volume customer locations. Thus while Dr. Bernheim is correct, in principle, that a loop could be a LEC bottleneck facility, that fact is accounted for in the USTA proposed standard for implementing streamlined or nondominant regulation. A customer location would not be counted as having a competitive alternative to the LEC unless the IXCs can reach it without using any LEC facilities whatever. Thus when IXCs have competitive access alternatives to reach 25 or 50 percent of the market, the degree to which LEC loops are a bottleneck facility is fully accounted for. To argue that a "much more demanding standard" should be applied in the carrier access market because some LEC facilities are bottlenecks is effectively double counting because the degree to which LEC facilities are bottlenecks in the first place is measured in the standard. Dr. Bernheim acknowledges this fact:

Although the LEC would not be able to handicap entrants offering complete, stand-alone, alternative networks, such an entry strategy involves enormous sunk costs and risks, especially if all of the preconditions for entry have not been effectively implemented. (Bernheim at 13).

Such sunk costs and risks have been voluntarily assumed by CAPs since the mid-1980s, presumably long before AT&T's preconditions for entry were effectively implemented.

In addition, the fact that some LEC facilities are inputs into interstate toll services is hardly the most significant way in which carrier access services differ from ordinary retail services. As described above, the two main reasons why ordinary market power analysis would tend to overstate LEC market power in the carrier access market are

- the fact that carrier access is an intermediate homogenous good, sold to a small number of knowledgeable customers for which access is a significant fraction of their cost of business, and
- the fact that IXCs can and do supply all manner of access facilities themselves, using their own networks.<sup>19</sup>

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<sup>19</sup> Thus AT&T's claim that the "LECs' only actual competitors are competitive access providers ("CAPs")" (AT&T at 2) is nonsense, as it ignores all direct connections between IXCs and their customers as well as all IXC network expansions that reduce carrier access charges.

The first fact implies that -- for a given market structure -- price competition in the carrier access market will be more vigorous while the second implies that ordinary measures of market structure and market power -- based on CAP capacity or market shares -- will understate the true competitiveness of the structure of the carrier access market.

Second, Dr. Bernheim recognizes the need to establish a simple quantitative test to use for implementing streamlined or nondominant regulation for LEC carrier access services.<sup>20</sup> However, the standard that he finds to be "insufficiently demanding" for additional LEC pricing flexibility -- that at least 30 percent of subscribers in an area use alternative suppliers for local exchange service -- is incorrect in principle and unrealistic in magnitude. It is incorrect in principle because (i) it ignores the fact that the LEC share of addressable capacity, not its share of current customers, determines the LEC's ability to affect the market price,<sup>21</sup> (ii) the CAP share of customers greatly understates their share of the market, because a grossly disproportionate share of long distance volume is consumed by high-volume business customer locations, (iii) ignoring IXC self-supply implies that measured LEC market share overstates the LEC's true share of the market because self-provisioned carrier access demand is never counted as part of the overall carrier access market, (iv) market share is not an adequate measure of market power while use of market share as a standard creates inefficient incentives for the regulated firm, and (v) the markets in question are carrier access markets, not local exchange markets.

In addition, Dr. Bernheim's -- and AT&T's -- proposed metric is unrealistic and would prevent LEC pricing flexibility in circumstances where anticompetitive pricing would be extremely unlikely. First, it is important to take into account the history and current level of LEC carrier access prices in appraising the likelihood of price increases that exploit market power. At divestiture, the contribution from interstate toll services that previously supported

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<sup>20</sup> Bernheim at 16-17.

<sup>21</sup> Dr. Bernheim repeats this error in his discussion of the geographic pervasiveness of competition (Bernheim at 11) where he notes that his standards for competition "must exist for 90% of end-users within the geographic unit that is used to define the relevant market." As noted in our earlier Reply Comments, AT&T has consistently stressed the difference between market share and market power and the use of capacity shares as a better measure of market concentration than output shares. See Schmalensee-Taylor, "Reply Comments: Market Analysis and Pricing Flexibility for Interstate Access Services," Attachment to the United States Telephone Association Reply Comments in CC Docket No. 94-1, June 29, 1994.

local exchange service was shifted to carrier access services, and — despite a decade of continuous price decreases — LEC carrier access prices, including substantial contribution in the form of CCL and RIC, exceed incremental costs. Pricing flexibility in the future could not exploit market power in carrier access markets any more thoroughly than regulation has exploited it in the past.

Second, withholding pricing flexibility for local telephone customers until at least 30 percent of local exchange customers use alternative providers is out of step with another market structure standard used by the Commission and specified in the Cable Act of 1992: that a cable system was deemed to face sufficient competition to warrant deregulation -- not merely pricing flexibility -- whenever a competitor offers service to 50 percent and serves more than 15 percent of the market. AT&T's proposed metric for LEC pricing flexibility would require twice the market share of competitive providers as the Cable Act requires for complete deregulation. In addition, of course, cable services are purchased by final consumers, not IXC's, are a small fraction of consumer expenditure and are far from homogeneous. By way of comparison, the USTA proposal permits streamlined regulation when competitors can address 25 percent of the market and nondominant regulation when the market is 50 percent addressable.

## **V. PRICE REGULATION REQUIRES LESS DEPENDENCE ON ACCOUNTING COSTS.**

On behalf of the cable industry, Dr. Johnson points to remaining theoretical links between accounting earnings and the price cap index for LECs and concludes that it is premature to grant LECs pricing flexibility and that -- on the contrary -- further accounting-cost safeguards should be imposed on LEC pricing to prevent cross-subsidization. In our view, both parts of this argument are wrong: the existence of such links in theory does not imply that price cap regulation exposes customers to real threats of cross-subsidization, and -- even if it did -- the cure of additional reliance on cost accounting is ineffective and exacerbates the disease it purports to cure.

First, the theoretical links between accounting losses for competitive services and price caps for less-competitive services cited by Dr. Johnson are tenuous, uncertain and incomplete.

Dr. Johnson argues that a price-cap-regulated LEC has an incentive to price competitive services below cost because it can offset its losses by (i) a reduced sharing obligation in the event of overearning, (ii) a larger increase in the price cap index in the event of underearning, or (iii) a smaller future productivity offset in the event the price cap plan is renegotiated. However, when the LEC sets its prices for competitive services, it has no knowledge of its future accounting earnings and does not know whether any of these events will occur that would mitigate its losses from its anticompetitive pricing.<sup>22</sup> Thus it would be foolhardy to set competitive service prices to lose money in the expectation that sharing at the end of the year -- or at the end of a three or five year review period -- would reduce its losses. Even if it knew with certainty that it would be sharing earnings, it is undeniable that its incentive to cross-subsidize would be lower than that of an ordinary rate-of-return regulated firm. Under the current (interim) price cap plan, if earnings happened to exceed an upper sharing threshold, a LEC that deliberately incurred losses to serve customers with competitive alternatives would still lose at least 50 cents on the dollar plus one or two years' interest on its losses. If earnings fell below a lower threshold, it would be able to offset losses until its interstate accounting rate of return reached 10.25 percent; however, further losses would have no effect on its price cap index.

Second, there is general agreement in the industry that the permanent price cap regulation plan under consideration at the Commission will further reduce the remaining vestigial backstop and sharing links between accounting earnings and the price cap index. The Commission has clearly stated a preference for the elimination of sharing, and the USTA proposal to replace a constant productivity offset X with a moving average would provide a self-correcting mechanism that would eliminate the need for frequent reviews of the plan.<sup>23</sup> With sharing and revisions of X eliminated, the only remaining link between current earnings and future changes in the price cap index would be a possible implicit mechanism to ensure continuity of service. Such a mechanism would not give rise to an incentive to underprice competitive services because (i)

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<sup>22</sup> Dr. Johnson evidently believes otherwise: see p. 12 where a LEC selects its X-factor "in order to protect its higher rate of return...of 16 percent."

<sup>23</sup> See Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, released: September 27, 1995, ¶114 and USTA's Comments filed in that proceeding.

it would only come into play under circumstances in which the entire carrier access market was so highly competitive that the LEC could not earn reasonable overall interstate returns, (ii) the LEC would have to anticipate its underearnings in its pricing decision, and (iii) the long-term prospect of gain from anticompetitive pricing in the carrier access market would have to outweigh the short-term certainty of loss.

Third, suppose there remained a weak and uncertain relationship between prices and earnings in one segment of the carrier access market and the price cap index for other segments of the carrier access market. Dr. Johnson's proposed cure for that problem is to

continue [FCC] oversight of cost assignments between more competitive and less competitive markets, until both have become effectively competitive. (at 3).

This policy prescription is internally inconsistent and would effectively reverse nearly a decade of reduced regulatory reliance on artificial accounting cost assignments to govern prices in markets opened to competition. It is inconsistent because it would strengthen, not weaken, the link between accounting costs and prices and increase, not reduce, the ability and incentive of the regulated firm to exploit its remaining market power by misallocating costs to less-competitive services.

Finally, Dr. Johnson observes that many states do not use pure price caps to regulate intrastate services and thus that

a threat of cross-subsidy would remain as a consequence of potential cost misallocations between the intrastate and interstate jurisdictions (at 13).

It is certainly true that many states do not practice pure price cap regulation, though the current trend in adoption of incentive regulation plans clearly favors plans without earnings sharing.<sup>24</sup> However, Dr. Johnson's analysis — applied to the interstate carrier access markets — comes to the opposite conclusion. Expenses and investment are allocated between interstate and intrastate jurisdictions by factors which largely depend on relative usage. If a LEC were to expand its interstate carrier access demand (or retain demand it would otherwise have lost to a competitor) through cross-subsidization or any other form of anticompetitive pricing, the effect would be to reduce, not increase, its

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<sup>24</sup> State price cap plans adopted recently (after 1993) that do not have an earnings-based sharing provision include Illinois, Ohio, Pennsylvania, Delaware, Virginia, Wisconsin, Maine and Massachusetts. There are sharing provisions in earlier price cap plans in California, New Jersey, Oregon and Rhode Island.

intrastate costs and prices. ,

In sum, while Dr. Johnson raises points that have some theoretical validity, they have no application in the interstate carrier access markets at hand. To mitigate the consequences of remaining uncertain links between interstate costs and interstate prices, it makes no sense to increase the use of accounting costs in determining interstate prices. In general, Dr. Johnson's stated concern<sup>25</sup> that LEC video dialtone services might be subsidized by basic local telephone service is misplaced in this forum, where the concern is rather that LECs might reduce prices to serve some carrier access customers below cost while increasing carrier access prices to other customers.

## VI. CONCLUSIONS.

The Commission should move forward to institute the changes in baseline regulation now; a competitive showing is not in the interest of the customers or market participants. Economic theory draws no observable bright lines -- establishes no numerical standards -- to determine when a service can be safely regulated by market forces. Even if it did, regulatory judgment would still be required to match the allowed amount of market power to the appropriate degree of regulation for each service to be classified. Moreover, market information is not solely in the possession of the telephone company and frequently derives from firms not subject to Commission jurisdiction or is simply unavailable. Finally, market share measurement is inherently backward-looking, and the results of the competitive assessment must pertain to the future. For these reasons, it is eminently sensible to resolve uncertainty by establishing "a rebuttable presumption of competition based on a simple set of clear, quantitative criteria"<sup>26</sup> and granting more symmetric regulation and pricing flexibility in markets where a sufficient fraction of customer demand faces a choice of suppliers. There are important disagreements regarding the criteria to be measured (e.g., capacity as opposed to number of customers) and

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<sup>25</sup> "My concern here is with competitive -- or potentially competitive -- services that share investment or recurring expenses with basic local exchange services." (Johnson at 6).

<sup>26</sup> Bernheim at 17.

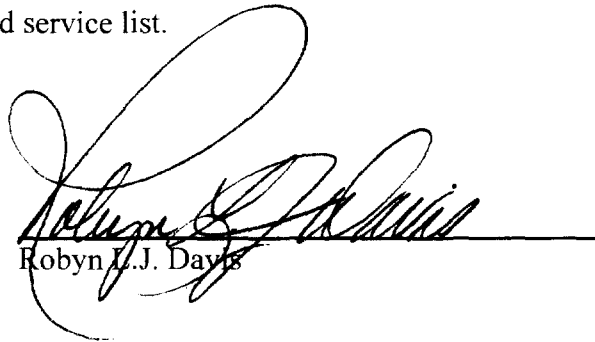
the quantitative standard for pricing flexibility (e.g., 25 percent addressable by a competitor as opposed to 75 percent addressable and 30 percent competitor market share applied to 90 percent of the customers in a geographic market).

In our opinion, the volume of demand in a market that is addressable by multiple suppliers is the appropriate criterion to be measured to gauge the remaining degree of market power. The number of customers addressable by or subscribed to competitors has no bearing on the ability of the LEC to raise price profitably above its competitive level, which is the hallmark of market power. We also believe that special characteristics of the carrier access market -- particularly its status as an intermediate homogenous service and the importance of self-supply -- imply that the lower end of the proposed standards offers sufficient regulatory protection to the (essentially) three large consumers of carrier access services. Explicit or implicit use of market share (of customers or addressable capacity) to trigger pricing flexibility would engender a whole new set of regulatorily-distorted incentives, and the ensuing market outcomes would not necessarily leave end-users better off.

There is probably general agreement that it is difficult to predict from historical data just how firms in a newly competitive telecommunications market will behave in the future. In our view, regulatory policy would better emulate competitive market outcomes if regulatory restrictions were lifted sooner, relying on monitoring and the implicit threat of stricter regulation rather than prediction to ensure that vestigial market power is controlled. Such a process would be particularly efficient compared with the alternative of retaining strict price regulation for each service until the LEC could demonstrate unequivocally -- service by service and market by market -- its inability to increase prices.

**CERTIFICATE OF SERVICE**

I, Robyn L.J. Davis, do certify that on January 11, 1996 reply comments of the United States Telephone Association were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.



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